Office of Chief Counsel
Internal Revenue Service

memorandum

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AAmmirato

date: AUG 0 3 2001

to: Frank Attianesi, Team Coordinator

from: Area Counsel
(Heavy Manufacturing, Construction and Transportation:Edison)

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subject: [redacted] - Section 367(b)

This memorandum responds to your request for assistance. This memorandum should not be cited as precedent. Your request involves the tax consequences of a cross border reorganization. Based on the facts as provided by the audit team, it appears that the taxpayer's treatment of the transaction is correct. However, as discussed below, the tax results of the transaction may vary if certain facts exist.

FACTS:

[redacted] (f.k.a. [redacted]), a U.S. corporation, is a wholly owned subsidiary of [redacted], a French corporation. [redacted] is a wholly owned U.S. subsidiary of [redacted] and is a member of the [redacted] consolidated group ("taxpayer"). [redacted] is a wholly owned U.S. subsidiary of [redacted] and is also a member of the [redacted] consolidated group. [redacted] is a wholly owned U.S. subsidiary of [redacted] and is also a member of the [redacted] consolidated group.[1]

[redacted][2] was a wholly owned subsidiary of [redacted] and was a controlled foreign corporation as described in section 957(a). Taxpayer is a U.S. shareholder with

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[1]The [redacted] group of corporations was acquired by taxpayer during [redacted]. The group consisted of a U.S. consolidated group and foreign operations (including controlled foreign corporations). Prior to the acquisition, [redacted], [redacted] and [redacted] were members of the former [redacted] consolidated group.

[2][redacted] was not a section 1504(d) corporation, and therefore, was not a member of the U.S. consolidated group.

respect to [redacted] pursuant to section 951(b).[3] [redacted], a foreign corporation, is a wholly owned subsidiary of [redacted].

On [redacted], [redacted] sales transferred its entire interest, [redacted]% of the outstanding common stock ([redacted] shares) of [redacted] ("[redacted]"), to [redacted] in exchange for [redacted] shares of Series I voting preferred stock of [redacted] ("[redacted]"). As part of the overall plan, [redacted] made a liquidating distribution (as of [redacted]) of all its assets and liabilities to [redacted]. Taxpayer indicated that the preferred stock represents [redacted]% of the outstanding preferred stock and approximately [redacted]% of the voting stock of [redacted]. Taxpayer valued the preferred stock received at $[redacted].[4] At the time of the exchange, [redacted] adjusted basis in the shares of [redacted] was $[redacted].[5] Therefore, [redacted] realized a gain of

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[3]Pursuant to sections 951(b) and 958(b) [redacted], [redacted], [redacted] and [redacted] are all "United States Shareholders". Since all corporations are members of the U.S. consolidated group, tax consequences of the subpart F provisions are determined on a consolidated basis.

[4]Out of the [redacted] shares received, [redacted] were held in escrow. As of the date of the reorganization, [redacted] and [redacted] were attempting to sell the assets of the "[redacted]", a division of [redacted]. The escrow agreement provided that if the value of the [redacted] assets owned by [redacted] exceeded a benchmark amount, [redacted] would receive all of the escrowed shares, and additional shares would be issued. To the extent that the amount received for the [redacted] assets was less than the benchmark amount, it would receive correspondingly fewer of the escrowed shares. In [redacted], the sale of the [redacted] business was less than the benchmark amount, therefore, [redacted] received only [redacted] of the escrowed shares. Taxpayer valued the shares actually received at $[redacted]. All of the [redacted] shares were valued as $[redacted].

[5]On [redacted], [redacted] sales contributed an intercompany receivable (liability of [redacted]) of $[redacted] to [redacted] in return for additional shares of [redacted]. Therefore, [redacted]'s liabilities decreased by $[redacted] increasing its fair market value by such amount. Correspondingly, [redacted] adjusted basis in the

$[redacted] from the exchange.

Taxpayer has taken the position that the transaction qualifies as a nontaxable reorganization under section 368(a)(1)(D). Furthermore, taxpayer determined that the application of section 367(b) results in a zero tax liability from the transaction.

Discussion

1. Based on the facts presented by the audit team, the transaction qualifies as a reorganization under section 368(a)(1)(D).

A "D" reorganization is defined as a transfer by a corporation of all or a part of its assets to a corporation controlled (immediately after the transfer) by the transferor or its shareholders, but only if stock or securities of the controlled corporation are distributed in pursuance of the plan of reorganization in a transaction that qualifies under sections 354, 355 or 356. Section 368(a)(1)(D).[6] If the distribution is to qualify under section 354 rather than 355, there must be a transfer of "substantially all of the assets" of the transferor. Section 354(b).

In our facts, [redacted] transferred [redacted]% of the common stock of [redacted] to [redacted] in return for [redacted]% of the voting preferred stock of [redacted] (constitutes approximately [redacted]% of total voting power). As part of the overall plan, [redacted] then liquidated into [redacted] Taxpayer has taken the position that the entire transaction should be viewed as a "D" reorganization, i.e. transfer by [redacted] to [redacted] of all its assets and liabilities in return for the [redacted]% preferred stock of [redacted] and a distribution of such stock to [redacted] in liquidation of [redacted]. Since both transactions were part of the overall plan, the Service has held in the past that the step transaction should be applied to such transactions and the transaction should be treated as a "D reorganization". See PLR 8823094. As such, taxpayer's position that the transaction should be viewed as a "D reorganization" should not be challenged, as long as all the requirements have

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stock of [redacted] increased from zero to $[redacted].

[6]Acquisitive type "D reorganizations" are not subject to the same continuity of ownership requirement as other reorganizations. Where section 354(b)(1)(A) or (B) are met, "control" is defined by reference to section 304(c)(at least 50% of vote or value). Section 368(a)(2)(H)(i).

otherwise been satisfied.[7]

[redacted] received [redacted]% of the voting preferred stock of [redacted]. The stock constitutes approximately [redacted]% of the voting power of [redacted] Therefore, [redacted] was not in control of [redacted] immediately after the transfer. However, after the transaction, [redacted] was controlled by [redacted], the ultimate shareholder of [redacted] and taxpayer("the transferor"). Thus, the control requirement of section 368(a)(1)(D) is met. Since section 355 has no application to our facts, the shares of [redacted], the "controlled corporation", must have been distributed in a transaction that qualifies under section 354, in order for the transaction to be viewed as a "D reorganization".

Section 354(a) provides, in general, that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.[8] The section does not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D) unless the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets, and the stock, securities and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization. Section 354(b)(1); Treas. Reg. 1.354-

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[7]The transaction could potentially be viewed as a "B reorganization" followed by a liquidation of [redacted] into [redacted] Regardless of whether the transaction is treated as a "D reorganization" or a "B reorganization" the U.S. tax consequences on taxpayer are governed by section 354 (either as a transfer of stock for stock between [redacted] and [redacted] or as a liquidation of [redacted]). The transaction can also be viewed as a liquidation of [redacted] into [redacted] and then a transfer of the assets of [redacted] by [redacted] to [redacted]. The liquidation would be governed under section 332. However, as discussed below, the tax results under section 367 may differ.

[8]Section 354(a)(2)(C)(i) provides that "nonqualified preferred stock" received in exchange for stock other than "nonqualified preferred stock" shall not be treated as stock or securities. "Nonqualified preferred stock" is defined by cross-reference to section 351(g)(2). Section 354(a)(2)(C)(i) applies to transactions after June 8, 1997. Although our transaction involved the receipt of preferred stock, since it occurred during [redacted], section 354(a)(2)(C)(i) has no application.

1.

In our facts, the transaction is treated as a transfer of all of the assets and liabilities of [redacted] to [redacted] in return for the voting preferred stock of [redacted]. [redacted] and [redacted] are parties to the reorganization. See section 368(b)(2). The preferred stock of [redacted], received by [redacted], is treated as distributed to [redacted] pursuant to the plan of reorganization, in exchange for the stock of [redacted] (liquidation of [redacted]). As such, the requirements of section 354 are satisfied.

In addition to the above statutory requirements, the following should be considered in determining whether the transaction qualifies as a tax free reorganization:

A restructuring of a corporate group is treated as a tax-free reorganization where readjustments of corporate structure are required by business exigencies and which effect only a readjustment of the continuity of interest and of the continuity of business enterprise under the modified corporate form. See Treas. Reg. 1.368-1(b). Therefore, taxpayer must have a valid non-tax business purpose for the reorganization. See also treas. reg. 1.368-2(g). Taxpayer provided, in part, the following statement of business purpose pursuant to treas. reg. 1.368-3(a)(1),

> "[redacted] ability to manage [redacted] assets and operate the [redacted] business more efficiently than [redacted] or [redacted] was the motivating factor behind the transfer of the [redacted] stock to [redacted] does not have [redacted] market expertise, so did not desire to directly own and manage a [redacted] operating company. [redacted] was a major [redacted] manufacturer and marketer. It had a large [redacted] distribution system, and expertise in the [redacted] market."

The audit team should verify the accuracy of this statement. If verified, such reasons appear to constitute a valid business purpose for the reorganization.

To qualify as a tax-free reorganization, the "continuity of business enterprise" requirement must be satisfied. Continuity of business enterprise requires that the acquiring corporation either, i) continue the acquired corporation's historic business or ii) use a significant portion of acquired corporation's historic business assets in a business. Treas. reg. 1.368-1(d)(2). **In our facts, the "[redacted]" of [redacted] was sold to a third party as part of the overall transaction. The audit**

team should determine the percentage of the [redacted] assets to the total business assets of [redacted] The audit team should also verify that the [redacted] assets (other than the [redacted] division) were used in [redacted]'s business in subsequent taxable years. Once this information is known, contact our office to determine if the "continuity of business enterprise" requirement has been satisfied.

Assuming a valid business purpose and continuity of business enterprise, the transaction would qualify as a reorganization under section 368(a)(1)(D). Therefore, taxpayer's exchange of the [redacted] stock for the [redacted] preferred stock would be governed by section 354. Since only the preferred stock of [redacted] was received in the exchange, section 356 (gain required to be recognized up to amount of other property received) has no application. As such, taxpayer would recognize no gain or loss on the exchange of stock.

Tax Impact on [redacted]

[redacted] was a foreign corporation which did not operate in the U.S. Since [redacted] did not have a trade or business or permanent establishment in the U.S., it was not subject to U.S. tax and the exchange of its assets has no U.S. tax consequences. Assuming there were U.S. tax consequences on [redacted], section 361(a) and section 361(c)(1) would prevent the recognition of gain or loss on the receipt of the [redacted] preferred stock and on the distribution of such stock to taxpayer in liquidation. Furthermore, the assumption of [redacted]'s liabilities by [redacted] would not result in recognized gain, assuming such liabilities did not exceed the adjusted basis of [redacted]'s assets and the principle purpose of the assumption of liabilities was not the avoidance of U.S. tax. See section 357(b) and (c).

Reporting Requirements

Treas. Reg. 1.368-3 provides that a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with a reorganization must be filed with the tax return for the taxable year within which the reorganization occurred. The following must be provided: 1) copy of the plan of reorganization, together with a statement executed under the penalties of perjury, showing in full the purposes thereof and in detail all transactions incident to, or pursuant to, the plan; 2) a complete statement of the cost or other basis of all property transferred incident to the plan; 3) a statement of the amount of stock or securities and other property or money received from the exchange, including a statement of all distributions made. The

amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value at the date of the exchange; and 4) a statement of the amount and nature of any liabilities assumed upon the exchange, and the amount and nature of any liabilities to which any of the property acquired in the exchange is subject. Taxpayer has provided information pursuant to treas. reg. 1.368-3.

2. Taxpayer is required to include the "section 1248 amount" of [redacted] in income pursuant to the regulations under section 367(b).

Section 367(a)(1)provides, "[i]f, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation." Section 367(a)(1) denies non-recognition treatment only to transfers of property on which gain is realized. Temp. Treas. Reg. 1.367(a)-1T. The amount of gain recognized is unaffected by transfers of items of property on which loss is realized (but not recognized).

Section 367(a) contains exceptions to the general rule that a foreign corporation is not treated as a corporation. Included is an exception for certain property to be used in the active conduct of a trade or business outside the United States (with certain exceptions). See Section 367(a)(3). In addition, Section 367(a)(2) provides, "except as provided in the regulations, paragraph (1) shall not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization." In defining "party to the reorganization", the regulations refer to section 368(b). Temp. Reg. 1.367(a)-1T(b)(2)(i).

In our facts, [redacted] and [redacted] are parties to the reorganization. Taxpayer exchanged, in a transaction described in section 354 transaction, all the shares of [redacted] in exchange for the voting preferred stock of [redacted], a foreign corporation. Pursuant to section 367(a)(2), section 367(a)(1) does not apply to the transfer. Although section 367(a) does not apply, section 367(b) applies.

Section 367(b)(1) provides that, **except as provided in the regulations**, a foreign corporation is considered a corporation in the case of an exchange described in section 332, 351, 354, 355, 356 or 361 to which there is no transfer of property described in section 367(a)(1). Section 367(b)(2) provides that such regulations include provisions determining when gain shall be recognized in connection with a sale or exchange of stock of a

foreign corporation by a United States person. In our facts, the temporary section 367(b) regulations apply to the year at issue.

Temp. Treas. Reg. 7.367(b)-7 applies to an exchange of stock in a foreign corporation if the exchange is described in section 354 or 356 and is made pursuant to a reorganization described in section 368(a)(1)(B) through (F) and the exchanging person is either a U.S. shareholder or a foreign corporation having a U.S. shareholder who is also a U.S. shareholder of the corporation whose stock is exchanged. Section 7.367(b)-7(b) provides that if an exchanging shareholder receives stock of a controlled foreign corporation, section 7.367(b)-9 applies if, with respect to such corporation, immediately after the exchange the exchanging shareholder is a United States shareholder of the controlled foreign corporation. Section 7.367-9 provides rules for attributing to the stock of the foreign corporation received, the earnings and profits of the foreign corporation exchanged attributable to the exchanging U.S. shareholder.

If the exchanging shareholder receives stock in a domestic corporation, or stock of a foreign corporation which is not a controlled foreign corporation, or stock of a controlled foreign corporation as to which the exchanging shareholder or any United Shareholder of the exchanging foreign corporation is not a United States Shareholder, then the exchanging United States shareholder shall include in gross income the section 1248 amount attributable to the stock exchanged, to the extent that the fair market value of the stock exchanged exceeds its adjusted basis (include section 1248 amount in gross income up to the amount realized). Treas. Reg. 7.367(b)-7(c)(1)(i).

"United States Shareholder" means any United States person who satisfies the ownership requirements of section 1248(a)(2) or (c)(2) with respect to a foreign corporation. Treas. Reg. 7.367(b)-2(b). Section 1248(a)(2) applies to a U.S. person who owns within the meaning of section 958(a) or (b) 10% or more of the combined voting power of all classes of stock entitled to vote of a foreign corporation at any time during a five year period (ending on the date of the exchange) while such foreign corporation was a controlled foreign corporation. A controlled foreign corporation is defined as any foreign corporation if more than 50% of the voting power of all classes of stock of such corporation entitled to vote and more than 50% of the total value of the stock of such corporation is owned by U.S. shareholders on any day during the taxable year of such foreign corporation. section 957(a). The attribution rules of section 958(a) and (b) apply in determining the ownership of the foreign corporation. Id.

"Section 1248 amount" refers to the net positive earnings and profits which would have been attributable under section 1248 to the stock of the foreign corporation exchanged if the stock had been sold in a transaction to which section 1248(a) applied. Treas. Reg. 1.367(b)-2(d). Earnings and profits of a foreign corporation attributable under section 1248 includes the earning and profits of such foreign corporation attributable to the stock of such corporation (owned by the U.S. person) which were accumulated in taxable years of such foreign corporation after December 31, 1962 and during the period(s) the stock was held by such person while such foreign corporation was a controlled foreign corporation. Section 1248(a)(flush language).

In our facts, [redacted] was a "controlled foreign corporation" and taxpayer was a "U.S. shareholder". Taxpayer exchanged all its stock in [redacted] in exchange for [redacted]% of [redacted]'s (foreign corporation) voting preferred stock. The preferred stock represents [redacted]% of [redacted]'s voting power. The common stock of [redacted] is owned by [redacted], a foreign corporation. [redacted] is not owned by any U.S. persons. Therefore, [redacted] is not a controlled foreign corporation and [redacted] is not a U.S. shareholder with respect to [redacted] As such, taxpayer was required to include in gross income the section 1248 amount attributable to the stock exchanged, to the extent that the fair market value of the stock exchanged exceeds its adjusted basis (include section 1248 amount in gross income up to the amount realized). Treas. Reg. 7.367(b)-7(c)(1)(i). Taxpayer realized a gain of $[redacted] on the transfer of the [redacted] stock in exchange for the [redacted] stock. Taxpayer indicated that the 1248 amount was zero, therefore, taxpayer included zero in gross income. **The audit team should verify the taxpayer's calculations and confirm that the section 1248 amount was zero.**

If a transfer is described in section 351 as well as section 354, 361 or so much of section 356 as relates to section 354, then temp. reg. 7.367(b)-4 and 7.367(b)-7 apply to the transaction. Temp. treas. reg. 7.367(b)-4 (b)(1) provides that if an exchange of stock in a foreign corporation by a U.S. person pursuant to a reorganization described in section 368(a)(1)(B) involving a foreign corporation transferee is described in section 351 or 361 as well as in section 354, such exchange is not an exchange described in section 367(a)(1) and -

i) if the exchanging shareholder is an "U.S. Shareholder" of the corporation whose stock is exchanged-

A) the exchange shall be subject to the rules of 7.367(b)-7, and

B) the excess of the gain realized over the section 1248 amount taken into account under 7.367(b)-7 shall be included in

the gross income of the exchanging shareholder as gain recognized from the sale or exchange of the stock exchanged.

As discussed above, the transaction is treated as a "D reorganization", therefore, temp. treas. reg. 7.367(b)-4 has no application.[9]

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[9]The tax consequences of the transaction under section 367 would not differ if the transaction was viewed as a "B reorganization" followed by a liquidation. However, the tax consequences may differ if the transaction is treated, for U.S. tax purposes, as a liquidation followed by the transfer of the assets.

If the transaction was treated as a "B reorganization", treas. 7.367(b)-4(b)(1) would tax the gain in excess of the 1248 amount as a gain from the sale or exchange of the stock if the exchange of the [redacted] stock by taxpayer was described in section 351 or 361 as well as 354. Section 354 would apply to taxpayer's exchange of stock in [redacted] for the [redacted] voting preferred stock. However, since taxpayer is not "in control" (section 368(c) more than 80% test) of [redacted] immediately after the transfer, the transaction does not qualify as a section 351 exchange. In order for the transfer of the [redacted] stock by taxpayer to qualify as a transfer described in section 361 the transaction would have to qualify as a "C reorganization" (section 361 would apply to the transfer of the [redacted] stock by taxpayer). In order to qualify as a section 368(a)(1)(C) reorganization, the stock of [redacted] must constitute "substantially all" of [redacted] assets. See Temp. Treas. Reg. 7.367(b)-13, ex. 14(e). "substantially all" generally requires a transfer of 70% of gross assets and 90% of net assets. See Rev. Proc. 77-37, 1977-2 C.B. 586. However, since the transaction would be described in section 368(a)(1)(D) and 368(a)(1)(C), it would be treated as described in 368(a)(1)(D). Therefore, the transfer of the [redacted] stock by [redacted] would not be described in section 361. As such, temp. treas. reg. 7.367(b)-4(b)(1) would not apply and taxpayer would be required to include in gross income only the "1248 amount" up to the gain realized.

If the transaction was treated as a liquidation of [redacted] followed by a transfer of the assets to [redacted], section 332 would prevent the recognition of gain or loss on the liquidation to taxpayer. However, in order for section 332 to apply taxpayer would be required to include in gross income the "all earnings and profits" amount of [redacted] See temp. treas. reg. 7.367-5(b). If the taxpayer did not elect to include the all earnings and profits amount in gross income, section 332 would not apply and

Reporting Requirements

If any person realized gain or other income (whether or not recognized) on account of any exchange to which section 367(b) applies, such person must file a notice of such exchange on or before the last date for filing a Federal income tax return for the taxable year in which the gain or other income is realized. Temp. Treas. Reg. 7.367(b)-1(c)(1). The following information must be included: i) a statement that the exchange is one to which section 367(b) applies; ii) a complete description of the exchange; iii) a description of any stock or securities received in the exchange; iv) a statement which describes any amount required, under §§7.367(b)-4 through 7.367(b)-12 to be included in gross income or added to the earnings and profits or deficit of an exchanging foreign corporation for the person's taxable year in which the exchange occurs; v) a statement which describes any amount of earnings and profits attributed by reason of the exchange under §§7.367(b)-4 through 7.367(b)-12, to stock owned by any U.S. person; vi) any information which is required to be furnished pursuant to regulations under section 332, 351, 354, 355, 356, 361 or 368 if such information has not otherwise been provided and vii) any information required to be furnished under section 6038 or 6046 if such information has not otherwise been provided. (The last two requirements have no application to our facts). Temp. Treas. Reg. 7.367(b)-1(c)(2).

If a person fails to timely provide information sufficient to apprize the Commissioner of the occurrence and nature of an exchange to which section 367(b) applies, the taxpayer will be considered to have failed to comply with the provisions of §§7.367(b)-1 through 7.367(b)-12 only if the taxpayer fails to establish reasonable cause for the failure. Temp. Treas. Reg. 7.367(b)-1(c)(3). **The audit team should review the information attached to taxpayer's return to verify that the reporting requirements have been complied with.**

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taxpayer would be required to recognize any gain or loss realized on the liquidation. In addition, taxpayer would be required to recognize any gain or loss realized on the transfer of the assets to [redacted] in return for the preferred stock (since the stock received represents only [redacted]% of the voting power of [redacted], therefore would not qualify under section 351).

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions please contact attorney Anthony Ammirato at (973)645-2539.

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